

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PIT:TL-N-7123-99
FAFalvo

date:

to: John Niederst, Case Manager

from: Associate District Counsel, Pennsylvania District, Pittsburgh

subject:

Like Kind Exchange

This document may contain taxpayer information subject to section 6103. This document may also contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. Therefore, this document shall not be disclosed to taxpayers or their representatives or disclosed or circulated beyond office personnel having the requisite "need to know."

ISSUES

1. Whether the State of Minnesota's involvement in an exchange of properties between the taxpayer and a third party affects the applicability of I.R.C. § 1031.
2. Whether new mining leases issued by the State of Minnesota qualifies as part of the section 1031 transaction.
3. Whether the assignment to the taxpayer of a special minimum royalty credit should be characterized as boot for the purposes of section 1031.
4. Whether a change in the fair market values of any of the exchanged properties would affect the applicability of section 1031.

CONCLUSIONS

1. The involvement of the State of Minnesota in the transaction does not affect the applicability of I.R.C. § 1031.
2. The issuance of the new mining leases by the State of Minnesota should not be considered part of the like kind exchange

between the taxpayer and [REDACTED].

3. The assignment of the special minimum royalty credit should not be characterized as boot for the purposes of section 1031(b).

4. An adjustment to the fair market values of the exchanged properties will not affect the applicability of section 1031.

FACTS

All of the facts set forth herein have been provided by the Examination Division.

Prior to [REDACTED], [REDACTED] held [REDACTED] State of Minnesota [REDACTED] and [REDACTED] mining leases covering [REDACTED] acres in [REDACTED] County, Minnesota. [REDACTED] owns and operates the [REDACTED] plant in [REDACTED] Minnesota. [REDACTED] is the [REDACTED] producer of [REDACTED]. [REDACTED] is owned [REDACTED] % by [REDACTED] and [REDACTED] % by [REDACTED]. Prior to [REDACTED], [REDACTED] held [REDACTED] State of Minnesota [REDACTED] mining leases covering [REDACTED] acres in [REDACTED] and [REDACTED] counties, Minnesota. [REDACTED] of those leases were in the [REDACTED] area. [REDACTED] of [REDACTED]'s leases were sublet to another entity partially owned by [REDACTED]. All of the state [REDACTED] leases held by [REDACTED] and [REDACTED] were acquired by the companies through public sales in the [REDACTED]'s and [REDACTED]'s. These acquisitions resulted in a mixed land control position by the [REDACTED] companies in the [REDACTED] area. The state leases are covered by extension agreements previously negotiated between the state and the lessees.

On [REDACTED], [REDACTED] and [REDACTED], a division of [REDACTED], entered into an agreement to exchange their respective fee simple interests in certain real property and certain existing leasehold interests in state owned land. The property and leases are located in [REDACTED] County, Minnesota and involve lands in which significant quantities of [REDACTED] is mined. The exchange agreement provides that no equalizing payment or "boot" is required to balance or complete the exchange. The purported economic reason for the exchange was so both parties could mine [REDACTED] in a more strategic and orderly fashion. The exchange agreement also requires the issuance of [REDACTED] new [REDACTED] mining leases to [REDACTED] by the State of Minnesota. [REDACTED] treated the exchange as a nontaxable like-kind exchange under I.R.C. § 1031.

According to the terms of the exchange agreement, [REDACTED]

agreed to convey to [REDACTED] [REDACTED] acres of land, and assign and convey certain leasehold interests covering three state [REDACTED] leases involving [REDACTED] acres of leased land. [REDACTED] agreed to convey to [REDACTED] acres of land and assign leasehold interests covering five state [REDACTED] leases involving [REDACTED] acres of leased land. Additionally, the exchange agreement provided that [REDACTED] agreed to surrender and convey to the State of Minnesota certain leasehold interests consisting of [REDACTED] acres and agreed to cooperate with [REDACTED] towards seeking a lease of said lands from the State of Minnesota to [REDACTED]. [REDACTED] also agreed to cooperate with [REDACTED] towards seeking new [REDACTED] leases with the State of Minnesota involving [REDACTED] acres of land.

[REDACTED] further agreed to lease to [REDACTED] mineable reserves of [REDACTED] ore that [REDACTED] owns in the [REDACTED] area. This lease involves [REDACTED] acres of land. The royalty rate payable by [REDACTED] to [REDACTED] was the same rate that [REDACTED] paid to the State of Minnesota under the proposed agreements covering this area.

For the purpose of obtaining appropriate state approval for the assignment of the state leases and the issuance of certain new leases by the State of Minnesota, a report concerning the transaction was submitted to the State of Minnesota. This report, which is identified by the examiner as Attachment C, states that under the terms of a prior extension agreement between the [REDACTED] and the State of Minnesota covering the state [REDACTED] leases in the [REDACTED] area, [REDACTED] had been paying the state a special minimum royalty in advance of mining. The special minimum royalty is available as a credit against royalties subsequently due on [REDACTED] removed from the state leased property. According to the report, the special minimum royalty credit available to [REDACTED] totaled \$[REDACTED] as of the date of the exchange agreement. The report states that [REDACTED] agreed to assign to [REDACTED] the right to use this credit. As [REDACTED] uses the credit with the state, it agreed to pay [REDACTED] at the rate of \$[REDACTED] per ton for each ton of [REDACTED] mined until the credit is fully used.

Although the report to the State of Minnesota describes the purported assignment of the special minimum royalty credit, neither the Tax Exchange Agreement nor the Land Exchange Agreement between [REDACTED] and [REDACTED] make any mention of this assignment. Therefore, from the documents provided to us, we are unable to verify whether the royalty credit was actually assigned by [REDACTED] to [REDACTED]. The examiner advises that the audit team does not know how the taxpayer is treating this credit.

[REDACTED]'s transfer of the state [REDACTED] leases required the consent of both the Minnesota Commissioner of Natural Resources

and the State Executive Council. In connection with the transfer, the state negotiated agreements with [REDACTED] and [REDACTED] concerning the state [REDACTED] leases. The State Executive Council approved the transfer of the [REDACTED] leases by [REDACTED] to [REDACTED]. It also approved separate agreements that the State entered into with [REDACTED] and with [REDACTED]. In addition, the Executive Council approved the issuance of [REDACTED] new [REDACTED] mining leases to [REDACTED]. The transfer of the state leased lands and the issuance of the new leases resulted in an increase in revenues to the state in the amount of approximately \$ [REDACTED] over a [REDACTED]-year period.

The agreement between the State of Minnesota and [REDACTED] covered the state leases in the [REDACTED] area and the leases transferred to [REDACTED]. The terms of the agreement provided for the deletion of [REDACTED] acres of land from the terms of [REDACTED] state [REDACTED] leases held by [REDACTED]. These [REDACTED] acres were then to be leased by the State of Minnesota to [REDACTED] through [REDACTED] new state [REDACTED] leases.

[REDACTED] state leases were transferred in their entirety by [REDACTED] to [REDACTED]. The agreement between [REDACTED] and the State of Minnesota further provided that the terms of the [REDACTED] lease extension agreement as to the statutory minimum rental, the special minimum royalty, the use of the special minimum royalty credits, and the royalty rate will no longer apply to those leases. The terms for those agreements were to be as provided in a separate agreement between [REDACTED] and the state.

The agreement between [REDACTED] and the state also provides that with respect to various leases transferred to [REDACTED] by [REDACTED], the terms of those state leases would not change.

The State of Minnesota also entered into a separate agreement with [REDACTED] covering state leases held by [REDACTED] and the leases being transferred to [REDACTED]. [REDACTED] of the new [REDACTED] leases issued to [REDACTED] cover the [REDACTED] acres of land deleted from the terms of the [REDACTED] leases held by [REDACTED]. Another of the new [REDACTED] leases covered [REDACTED] acres of land containing minable [REDACTED]. The other new [REDACTED] lease issued to [REDACTED] covered [REDACTED] acres of land known as the [REDACTED], containing [REDACTED] reserves. The new [REDACTED] leases were effective for the period from [REDACTED] through [REDACTED]. The agreement provided lease terms concerning the payment to the state of minimum rentals, special minimum royalty payments and royalty rates along with specified production guarantees.

DISCUSSION

1. I.R.C. § 1031(a) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. Thus, for an exchange to be valid under section 1031, the transaction must satisfy three requirements: (1) there must be an exchange; (2) the properties exchanged must be of like kind; and (3) the properties relinquished and received in the exchange must be held for productive use in a trade or business or for investment.

An exchange is not limited to reciprocal transfers between two parties. Multiple party and "accommodating" party exchanges are allowed. Rev. Rul. 77-297, 1977-2 C.B. 304. However, where a party acts as a mere conduit or agent for the taxpayer, the exchange is not cognizable under section 1031.

Treas. Reg. § 1.1031(a)-1(b) provides that as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Section 1031(b) provides that if an exchange would be within the provisions of subsection (a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provision to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Rev. Rul. 68-226, 1968-1 C.B. 362 provides that the interest of a lessee in oil and gas in place is an interest in real property. Rev. Rul. 68-331, 1968-1 C.B. 352 provides that the exchange of oil, gas and mineral rights for a fee interest in a parcel of improved property was an exchange of properties of a like kind.

In this case, the direct exchange between [REDACTED] and [REDACTED] of the fee interest in the real property and the leasehold interests appear to comply with the requirements of section 1031. Ordinarily, to constitute an exchange, a transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only. Treas. Reg. §1.1002-

1(d). The transaction herein involved a simultaneous exchange of property by [REDACTED] for property owned by [REDACTED]. These properties were presumably of approximately equal values, although that fact has not been verified. Thus, the transaction constituted an exchange. Secondly, [REDACTED] relinquished and received only real property and leasehold interests. All of the properties involved in the transaction were of a like kind. Finally, the properties relinquished and the properties received by the taxpayer are held for the productive use in the trade or business or for investment. Accordingly, with respect to the properties received directly by [REDACTED] from [REDACTED], the transaction appears to meet the requirements of section 1031. The fact that the State of Minnesota was required to approve the assignments of the leases and entered into new leases with the parties does not appear to affect the applicability of section 1031 as to the exchange of property directly between [REDACTED] and [REDACTED].

In addition, as previously discussed, part of the exchange agreement provided that [REDACTED] would surrender and convey to the State of Minnesota a portion of [REDACTED] state [REDACTED] leases consisting of [REDACTED] acres of land. In this regard, [REDACTED] also agreed to cooperate with [REDACTED] towards seeking a lease of these [REDACTED] acres from the State of Minnesota to [REDACTED]. The state and [REDACTED] did enter into [REDACTED] new [REDACTED] leases for these [REDACTED] acres. We believe that the use of the state to effectuate the transfer of the leasehold interests in the [REDACTED] acres does not disqualify the exchange under section 1031.

2. As discussed above, the agreements among the parties provided that [REDACTED] would cooperate and work with [REDACTED] towards seeking leases from the State of Minnesota on [REDACTED] acres of land in [REDACTED] County, Minnesota. These apparently are [REDACTED] new leases which were issued by the state to [REDACTED]. In order to qualify under section 1031, there must be an exchange of like kind property between or among the parties. With respect to the issuance of the new leases, we are unable to ascertain how this constituted an exchange. From the information available to us, there appears to be nothing exchanged with the state for the issuance of the new leases. [REDACTED] agreed to assist [REDACTED] in securing [REDACTED] new state leases. The state did, in fact, enter into the new leases with [REDACTED]. However, the transaction does not appear to involve any exchange of property with the state. As a result, we believe that the issuance of the two new leases does not qualify as a like kind exchange under section 1031.

3. As stated above, I.R.C. §1031(b) provides that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in the exchange consists not only of property permitted to be received without

the recognition of gain, but also of other property or money, the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. Under section 1031(c), the loss, if any, to the taxpayer from such an exchange not solely in kind will not be recognized to any extent. Treas. Reg. §1.1031(b)-1(a)(1). "Other property" is either property specifically excluded under section 1031(a)(2) or property which is not of like-kind with property given in the exchange.

Ontario purportedly made advanced royalty payments to the State of Minnesota on certain state [REDACTED] leases. These advanced payments totaled approximately \$[REDACTED] and were available for use by [REDACTED] as a credit against royalties subsequently due on [REDACTED] removed pursuant to certain state leases. According to the examiner, when the state [REDACTED] leases were assigned by [REDACTED] to [REDACTED], [REDACTED] also assigned to [REDACTED] the right to use this credit with respect to [REDACTED] mined on those leases assigned by [REDACTED]. As this credit was used by [REDACTED], it was obligated to pay to [REDACTED] a fixed sum for each ton of [REDACTED] mined from the leased property until the credit was fully used. As a result, [REDACTED] apparently fully compensated [REDACTED] for the use of the state royalty credit. The examiner states that the audit team has no knowledge as to how this credit was treated by [REDACTED]. Additionally, the exchange agreements between [REDACTED] and [REDACTED] do not address the assignment of the advanced royalty credits. Therefore, we are unable to verify whether an assignment of the credits actually occurred.

Even assuming that the advanced royalty credits were assigned to [REDACTED], we believe that the assignment does not constitute the receipt of boot by [REDACTED]. The right to use the credit does not appear to be a receipt of other property by [REDACTED]. Although [REDACTED] could use the credit against royalties owed to the state, [REDACTED] was obligated to pay a specified royalty to [REDACTED] as it used the credit with the state until the credit was fully used. The payment of this royalty to [REDACTED] fully compensated [REDACTED] for [REDACTED]'s use of the credit on the leases assigned to [REDACTED]. [REDACTED] did not receive property which had value separate from its obligation to compensate [REDACTED] for the use of the credit. Instead, as [REDACTED] used the credit with the state, it was obligated to fully compensate [REDACTED] for the use of the credit. In our view, this does not constitute the receipt of other non-like property by [REDACTED].

4. Your memorandum asks what impact would a change to the fair market value of either participant have in this transaction. Section 1031 provides an exception from the general rule requiring the current recognition of gain or loss realized upon

the sale or exchange of property. As discussed herein, under section 1031(a), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Section 1031 provides an exception only from current recognition of gain realized. The realized gain is deferred until the exchanged property is disposed of in a subsequent transaction. In a section 1031 transaction, gain is recognized only to the extent of the sum of the money and the fair market value of the other property received. If no boot is received, no gain is recognized in a transaction which is otherwise allowable under section 1031.

An exchange of "like kind" refers to the nature or character of the property and not to its grade or quality. Therefore, the direct exchange between [REDACTED] and [REDACTED] of the fee interests in the real estate and the leasehold interests are an exchange of like kind property. The fact that there may be a discrepancy between the values of the exchanged properties does not result in the recognition of gain or loss by the parties or the inapplicability of section 1031. If the exchange meets the requirements of section 1031 and no boot is received, the disparity in values will not cause gain or loss to be recognized.

The advice rendered herein shall be submitted to the National Office for post-review and may be subject to change. If you have any questions in this matter, please contact Attorney Frank A. Falvo at 644-3417.

EDWARD F. PEDUZZI, JR.
Associate District Counsel